Excerpt from IRS Publication 15 (Rev. January 2003)
Section 7, Supplemental Wages

Supplemental Wages are compensation paid in addition to the employee's regular wages. They include, but are not limited to, bonuses, commissions, overtime pay, payments for accumulated sick leave, severance pay, awards, prizes, back pay and retroactive pay increases for current employees, and payments for nondeductible moving expenses. Other payments subject to the supplemental wage rules include taxable fringe benefits and expense allowances paid under a nonaccountable plan. How you withhold on supplemental payments depends on whether the supplemental payment is identified as a separate payment from regular wages

Supplemental wages combined with regular wages.
If you pay supplemental wages with regular wages but do not specify the amount of each, withhold income tax as if the total were a single payment for a regular payroll period.

Supplemental wages identified separately from regular wages.
If you pay supplemental wages separately (or combine them in a single payment and specify the amount of each), the income tax withholding method depends partly on whether you withhold income tax from your employee's regular wages:

1) If you ***withheld*** income tax from an employee's regular wages, you can use one of the following methods for the supplemental wages:

   a) Withhold a flat 27% (no other percentage allowed).
   b) Add the supplemental and regular wages for the most recent payroll period this year. Then figure the income tax withholding as if the total were a single payment. Subtract the tax already withheld from the regular wages. Withhold the remaining tax from the supplemental wages.

2) If you ***did not withhold*** income tax from the employee's regular wages, use method **b** above. (This would occur, for example, when the value of the employee's withholding allowances claimed on From W-4 is more than the wages.)

Regardless of the method you use to withhold income tax on supplemental wages, they are subject to social security, Medicare, and FUTA taxes.

Example 1. You pay John Peters a base salary on the 1st of each month. He is single and claims one withholding allowance. In January of 2003, he is paid $1,000. Using the wage bracket tables, you withhold $57 from this amount. In February 2003, he receives salary of $1,000 plus a commission of $2,000, which you include in the regular wages. You figure the withholding based on the total of $3,000. The correct withholding from the tables is $388.

Example 2. You pay Sharon Warren a base salary on the 1st of each month. She is single and claims one allowance. Her May 1, 2003, pay is $2,000. Using the wage bracket tables, you withhold $207. On May 14, 2003 she receives a bonus of $2,000. Electing to use supplemental payment method **b**, you:

1) Add the bonus amount to the amount of wages from the most recent pay date ($2,000 + $2,000 = $4,000).
2) Determine the amount of withholding on the combined $4,000 amount to be $658 using the wage bracket tables.
3) Subtract the amount withheld from wages on the most recent pay date from the combined withholding amount ($658 - $207 = $451).
4) Withhold $451 from the bonus payment.

Example 3. The facts are the same as in Example 2, except that you elect to use the flat rate method of withholding on the bonus. You withhold 27% of $2,000, or $540, from Sharon's bonus payment.

Vacation pay. Vacation pay is subject to withholding as if it were a regular wage payment. When vacation pay is in addition to regular wages for the vacation period, treat it as a supplemental wage payment. If the vacation pay is for a time longer than your usual payroll period, spread it over the pay periods for which you pay it.